FILE COPY

Office-Supreme Court, U.S.
FILED
DEC 28 1959
JAMES R. BROWNING, Clerk

No. 553

In the Supreme Court of the United States

October Term, 1959

LA GLORIA OIL AND GAS COMPANY and LA GLORIA CORPORATION, PETITIONERS

v.

FRANK SCOFIELD, Formerly Collector of Internal Revenue, First District of Texas

---

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

J. LEE RANKIN,
Solicitor General,

CHARLES K. RICE,
Assistant Attorney General,

MELVA M. GRANEY,
C. MOXLEY FEATHERSTON,
Attorneys,
Department of Justice,
Washington 25, D. C.

INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes and Regulations involved	2
Statement	3
Argument	6
Conclusion	11
Appendix	12

CITATIONS

Cases:

Commissioner v. *Southwest Exploration Co.*, 350 U.S. 308 ..... 7, 9, 10
Helvering v. *Bankline Oil Co.*, 303 U.S. 362 ..... 6, 7, 8, 9, 11
Hudson Engineering Corp. v. *Commissioner*, 183 F. 2d 180, affirming *per curiam Hudson* v. *Commissioner*, 11 T.C. 1042 10
Palmer v. *Bender*, 287 U.S. 551 ..... 7, 8, 10
Parsons v. *Smith*, 359 U.S. 215 10
Peurifoy v. *Commissioner*, 358 U.S. 59 9

Statutes:

Internal Revenue Code of 1939:
Sec. 23(m) (26 U.S.C., 1952 ed., 23(m)) 6, 12
Sec. 114(b) (26 U.S.C., 1952 ed., 114(b)) 6, 12

Miscellaneous:

Treasury Regulations 111, Sec. 29.23(m)-1 ..... 8, 13
Treasury Regulations 118, Sec. 39.23(m)-1 11

In the Supreme Court of the United States

October Term, 1959

No. 553

LA GLORIA OIL AND GAS COMPANY and LA GLORIA CORPORATION, PETITIONERS

v.

FRANK SCOFIELD, Formerly Collector of Internal Revenue, First District of Texas

---

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and conclusions of law of the District Court (Pet. 60a-83a) are reported at 171 F. Supp. 617. The opinions of the Court of Appeals for the Fifth Circuit (Pet. 3a-59a) are reported at 268 F. 2d 699.

JURISDICTION

The judgment of the Court of Appeals was entered on June 16, 1959. (Pet. 1a.) A petition for rehearing was denied October 9, 1959. (Pet. 2a.) The petition for certiorari was filed November 30, 1959. (Pet. 20.) The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a taxpayer, which received a one-half interest in heavy hydrocarbons derived from gas under a contract with the owners of oil and gas leases to operate facilities to separate such heavy hydrocarbons from the gas produced under the leases and to return the remaining gas to the ground, was entitled to a deduction for mineral depletion under the Internal Revenue Code of 1939.[1]

STATUTES AND REGULATIONS INVOLVED

Section 23(m) and Section 114(b)(3) of the Internal Revenue Code of 1939, and Section 29.23(m)-1 of Treasury Regulations 111 are set forth in the Appendix, *infra*, pages 12-14.

---

[1] In view of its decision on this question, the "secondary" question stated in the petition (Pet. 3) was not reached by the court below (but see n. 4, Pet. 20a). Since the answer to the second question, even if it were in accord with the argument of the petitioners, has no bearing on the correctness of the judgment below, the issue is not properly before this Court.

STATEMENT

The taxpayer brought suit for the recovery of income taxes alleged to have been overpaid. The District Court made findings of fact and conclusions of law (Pet. 60a-83a) and entered judgment for the taxpayer (Pet. 84a-86a). The Court of Appeals for the Fifth Circuit, with one judge dissenting, reversed the judgment of the District Court. (Pet. 3a-59a.)

The important facts may be summarized as follows:

In 1940, certain oil and gas companies and individuals owned interests in undeveloped oil and gas leases in the La Gloria Field in Texas. The natural gas underlying the area is a so-called wet gas of which about 94% consists of the lighter hydrocarbon compound of methane and approximately 6% of which consists of heavier hydrocarbon compounds. Each of these hydrocarbon compounds exists in a natural vapor state in high pressure reservoirs. (Pet. 5a.)

The heavier hydrocarbons can be produced only by separating them from the methane and there was no substantial market for the methane in the La Gloria Field area. Flaring the unmarketable methane violates the gas conservation laws of Texas. The only feasible method of producing the heavier hydrocarbons involves returning the residue gas (the methane) to the gas producing formations. Reinjecting the residue gas prevents its waste, helps maintain pressure in the underground reservoir as an aid to the production of the natural gas, and prevents loss of the heavier hydrocarbons through retrograde condensation. (Pet. 5a-6a.)

On June 4, 1940, the taxpayer entered into an agreement with the then owners of certain leases in the La Gloria field. Under this agreement the taxpayer agreed to use its best efforts to unitize the participating area; to construct a cycling plant with a capacity of at least 150,000,000 cubic feet of gas per day; to drill and equip enough wells (not exceeding 20) to produce 150,000,000 cubic feet per day, but for which it was to be repaid from the lease owners' share of the production of heavier hydrocarbons; and to operate the plant when completed, processing the natural gas and returning the residue gas to the producing formations. The term of the agreement was for the life of the leases, with taxpayer having the right to suspend operations if production diminished below a designated quantity. Under stated conditions the taxpayer could process gas of others not parties to the contract. In consideration of taxpayer's investments, undertakings and processing of the gas it acquired 50% of the heavier hydrocarbons "contained in all gas to be produced from" the leases. (Pet. 6a-8a.)

On June 16, 1941, the taxpayer entered into another agreement with the owners of leases in the South La Gloria Unit. On May 31, 1943, the taxpayer entered into an agreement with the then owners of other leaseholds in the Moos Unit. The general substance and economic effect of both of these instruments are similar to that of the first agreement of June 4, 1940. (Pet. 8a.)

Pursuant to these agreements the taxpayer secured execution of unitization agreements; constructed its

natural gas cycling plant with its requisite processing facilities, compressors, gathering lines, return lines and meter stations, and caused sixteen gas wells to be drilled and equipped in the field, all of which cost about $5,452,000. The taxpayer was reimbursed from the owners' share of the minerals for the cost of drilling and equipping the wells. (Pet. 8a-9a.)

The agreements did not purport to convey to the taxpayer the heavier hydrocarbons in place. They specifically provided that the wells, casing equipment and top well connections should belong to the lease owners and that the lease owners would be in complete control of the wells and that they would deliver the gas into the taxpayer's gathering systems. The taxpayer had no right to enter, drill or take any gas except as delivered to it at the top well connections of the lease owners. The contracts were not assignable by the taxpayer and they specifically provided: "No deed of trust, mortgage, lien or other encumbrance of any kind or character whatsoever arising out of buyer's [the taxpayer's] operations *shall attach to or affect Seller's oil and gas mining leases or the production therefrom or* [*any*] *interest therein.*" (Pet. 17a-18a.)

Some 20% of the total sales by the taxpayer (not included in those as to which depletion is here in dispute) were of heavier hydrocarbons of identical kinds from gas furnished to the taxpayer by others than the owners of the three units covered by the contracts of June 4, 1940, June 16, 1941, and May 31, 1943. (Pet. 11a.)

The decision of the Court of Appeals, holding that taxpayer is not entitled to a depletion allowance, was based on the ground that taxpayer did not have an economic interest in the gas in place so as to permit a depletion allowance. (Pet. 11a-23a.)

ARGUMENT

1. In all material respects, the present case is similar to *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362. In that case the taxpayer operated a casing-head gasoline plant and agreed with certain oil producers that it would process natural gasoline from wet gas delivered to it for that purpose. It agreed to install and maintain the necessary pipelines and connections for casing-heads or traps at the mouth of the well, through which the producers were to deliver the natural gas. In its contracts, the taxpayer agreed to pay the producers 33⅓% of the gasoline or a similar percentage of its gross sales price or to purchase the gasoline at a price of 33⅓% of the gross proceeds of its sale. Some of the residual dry gas was sold, some flared and wasted, and some was returned to the wells for pressure purposes. The taxpayer claimed, but was denied, a deduction for depletion. This Court held that the taxpayer, through its contracts, obtained only an economic advantage from the production of the gas, rather than an economic interest in the gas in place, and was not entitled to a depletion deduction under the practically identical predecessors of Sections 23(m) and 114(b)(3) of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 12-13).

The *Bankline* case is not distinguishable in principle from the present one. In both cases the taxpayers entered into contracts for wet gas to be delivered to them by producers; both installed and maintained pipelines for gathering the wet gas and transporting it from the wells to their plants; both processed marketable gasoline or other hydrocarbons from the wet gas; and both divided the proceeds of the marketable products with the producers of the wet gas. In both cases processing the wet gas was essential to the production of the marketable product —gasoline in the *Bankline* case and the heavy hydrocarbons in the present case. In neither case did the taxpayer acquire any interest in the leases or the wells except the right to receive and process the wet gas as it was produced. The Court of Appeals correctly concluded (Pet. 17a) that "Conceptually, the La Gloria case is very close to Bankline."

2. There is no conflict of decisions. The principles enunciated and applied in the cases cited by the taxpayer are the same as those applied in *Bankline*.

In *Palmer* v. *Bender*, 287 U.S. 551, and again in *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, both cited by taxpayer as stating a concept of "economic interest" inconsistent with that applied by the court below, this Court held that a taxpayer is entitled to a depletion deduction where he has (1) acquired, by investment, an interest in the oil [or gas] in place and (2) secured by any form of legal relationship, income derived from the extraction of the oil [or gas] to which he must look for a return of

his capital.[2] The court below applied those factors, concluding that, like *Bankline*, the taxpayer did not have an economic interest in the gas in place. The investment in a processing plant (recoverable for tax purposes through depreciation deductions) did not represent an investment in the gas in place. The taxpayer's argument to the contrary, consisting simply of an assertion that the minerals themselves are the capital investment (Pet. 14-15), begs the very question to be decided, as the court below stated (Pet. 21a). Moreover, the taxpayer was not required to look solely to the extraction of the gas from the particular properties for the recovery of its investment; since it could connect its pipelines with other wells either before or after the wells on these leases were exhausted. In fact during the years in suit, as contemplated by the contracts, about twenty percent of the wet gas processed by the taxpayer came from leases unrelated to the three units covered by the contracts which were the subject of this litigation.[3] In

---

[2] Treasury Regulations 111, Section 29.23(m)-1 (Appendix, *infra*, pp. 13-11), adopt almost literally the language from *Palmer* v. *Bender*, *supra*, coupled with the distinction made in the *Bankline* decision, *supra*, between an economic interest and an economic advantage.

[3] The taxpayer asserts (Pet. 19) that the court below was in error and based its conclusion that the taxpayer was not required to look solely to the La Gloria, South La Gloria and Moos Units for the recovery of its capital investment on an erroneous interpretation of the facts. Both the majority opinion (Pet. 11a-12a, 21a) and the dissenting opinion (Pet. 52a-55a) considered this point and agreed that the taxpayer could, and did, in the tax years, process gas from other wells. The La Gloria Unit agreement (R.

brief, under its contracts with the producers taxpayer acquired only the exclusive right to process the wet gas in its plant. In *Bankline* such a right was described as an economic advantage from the production of gas rather than an economic interest in the gas in place.

The decision below does not conflict with *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308. In that case, Southwest, seeking an oil lease from the State of California to drill under off-shore waters, was required to show an effective agreement permitting it to drill wells slant-wise from the surface of upland owners. Southwest met this requirement by obtaining an easement from Huntington Beach Company and other upland owners in consideration of 24½% of its net profits from the oil deposits. Carefully limiting its decision (p. 317) to "the circumstances of this case", the Court held that, since use of the upland owners' land was indispensable to the lease arrangement, the upland owners were not strangers dissociated from the lease—that they ac-

---

62-65) and the South La Gloria Unit agreement (R. 94-95) specifically reserved to the taxpayer the right to process wet gas from other leases and the Moos Unit agreement contained no prohibition against its doing so. The undisputed testimony was that the taxpayer did process gas from other leases and that such gas from other leases amounted to about twenty percent of the total amount of wet gas processed in the plant. (R. 172-173, 179-180.) The argument advanced by the taxpayer on this point was included in a motion for rehearing which was denied by the court below. In any event, a factual issue of this kind does not call for the exercise of this Court's certiorari jurisdiction. Cf. *Pourciau* v. *Commissioner*, 358 U.S. 59.

quired an economic interest in the oil in place by contributing "the use of their land in return for rental based on a share of net profits" (p. 316). In other words, the upland owners occupied a position similar to that of the ordinary owner of the surface on which drilling is to be done.

The court below correctly concluded that the taxpayer here was a stranger dissociated from the lease. Its rights were limited to the processing of gas delivered to it by others and its income was dependent upon the performance of personal services in the processing of the gas, either from the wells covered by the three contracts relied upon by the taxpayer or from other wells. Neither one of the requisites to an economic interest in the gas in place, as enunciated in *Palmer* v. *Bender*, *supra*, and reiterated in *Commissioner* v. *Southwest Exploration Co.*, *supra*, was present.[4]

Nor is the decision below in conflict with *Parsons* v. *Smith*, 359 U.S. 215. In that case the Court, holding that a strip miner of coal did not have an economic interest in the coal in place, reaffirmed the principles applied in *Palmer* v. *Bender*, *supra*, and

---

[4] As the court below stated (Pet. 17a-18a), its prior decision in *Hudson Engineering Corp.* v. *Commissioner*, 183 F. 2d 180, affirming *per curiam Hudson* v. *Commissioner*, 11 T.C. 1042, cited by taxpayer (Pet. 17-18), is distinguishable from the instant case. There the taxpayer was conveyed a fractional interest in the heavier hydrocarbons in place; was given the right to enter on the land to produce the gas; could, and did, assign to others fractional interests in its interest in the heavier hydrocarbons; and was specifically obligated to pay taxes to the extent of its interest in the leases.

Helvering v. *Bankline Oil Co.*, *supra*. No new criteria were adopted for identifying the possessor of an economic interest in minerals in place.

CONCLUSION

The decision below is correct and no conflict of decisions is involved. The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

MELVA M. GRANEY,
C. MOXLEY FEATHERSTON,
Attorneys.

DECEMBER 1959.

APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * *

(26 U.S.C., 1952 ed., 23(m).)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * *

(b) *Basis for Depletion.*—

* * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable

year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *

(26 U.S.C., 1952 ed., 114(b).)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.23(m)-1. *Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements.*—Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the

latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * *

Section 39.23(m)-1 of Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939, applicable to the taxpayer's fiscal year 1952, is substantially the same as the above-quoted section of Treasury Regulations 111, which is applicable to the taxpayer's fiscal years 1947-1951, inclusive.

☆ U. S. GOVERNMENT PRINTING OFFICE 1959 534858 824